U.S. Small Business Administration
SBA
Your Small Business Resource

UNITED STATES GOVERNMENT
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Tips on Buying or Selling a Business with SBA Financing

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Owning a small business is a risky business but one way to reduce the risk is to buy an existing successful business. That confidence does come at a price, as the buyer will need to spend more time making sure they have bought the RIGHT business rather than start one from scratch. If they have the funds, it can be an excellent option to consider.

Many find the idea of running a small business appealing, but lose their motivation after dealing with business plans, investors, and legal issues associated with new start-ups. For those disheartened by such risky undertakings, buying an existing business is often a simpler and safer alternative.

Here are some Key Advantages: The main reason to buy an existing business is the drastic reduction in start-up costs of time, money, and energy. In addition, cash flow may start immediately thanks to existing inventory, receivables or clientele. Other benefits include pre-existing customer goodwill and easier financing opportunities, if the business has a positive track record.

And some Key Disadvantages: The biggest block to buying a small business outright is the initial purchasing cost. Because the business concept, customer base, brands, and other fundamental work has already been done, the financial costs of acquiring an existing business is usually greater then starting one from nothing.

Other possible disadvantages include hidden problems associated with the business goodwill and receivables that are valued at the time of purchase, but later turn out to be non-collectable. This is often called "Blue Sky" and most lenders in Arizona require the Seller to carry this amount of the purchase back as a subordinated loan. Good research is the key to avoiding these problems. SBA can offer a loan guaranty to a participating lender up to $2 million with the term based on the type of assets being financed.

There are two basic rules for anyone who attempts to purchase a small business must consider.

First Rule: Get *Professional Assistance*.

A business-savvy attorney should be considered for all but the smallest business acquisitions since they can represent you, review legal documents or just act as a mentor. They can also act as an escrow agent or recommend a company to handle the exchange of money for the enterprise that you are thinking of acquiring. Some attorneys or business brokers that are not as familiar with the tax, accounting, or financing aspects of small business transfers, so it may be a good idea to run the deal by a qualified CPA or accountant.

If buying a business for more than the value of its "hard" assets (i.e. Goodwill) is contemplated, consult with a qualified business appraiser to make sure you have a true value a lender (and the SBA). It is preferable to find someone with experience in valuing businesses in the same industry and if you are considering SBA financing, understands SBA's regulations concerning business valuations. This is were SBA's resource partners, SCORE, Small Business Development Centers or Women Business Centers can be invaluable for free training or counseling. They can help you find a qualified business appraiser.

Please remember that buyers and sellers are natural adversaries even if they are family or friends. The broker is intensely interested too, because the commission amount is usually based on a percentage of the total selling price.

Rule Two: ***Do Your Homework.***

Because buying a business will involve investing a fair amount of money and time, it is critical to pre-purchase homework when gathering information about the business. This process is commonly referred to as "conducting due diligence." It is very important that you have thoroughly checked out the business — its financial performance, assets, liabilities, contracts, employees and more – before entering into any legal agreements.

In most purchases of small businesses, the buyer will want to learn everything possible about a business before signing the purchase agreement. If there isn't time to do that, then the buyer will want to make sure that the representations of the seller concerning the business are quite comprehensive and that the definitive agreement allows them to back out of the deal if the due diligence done after signing the purchase agreement. If you are considering SBA financing to help finance the purchase or sale, this is a strict requirement.

There are a number of issues to consider when contemplating purchasing a business. These include what type of deal will it be - purchasing the assets of the business or purchasing the stock. Will the seller share confidential information, such as financial statements and customer lists? Most buyers will be asked to sign a Confidentiality Agreement. Please note that if you are considering financing as a way to purchase the business, the seller must provide historical financial information to be eligible for SBA financing.

You will need a comprehensive definitive agreement setting forth the terms of the acquisition. Who will handle the legal review? If the purchase is for a significant amount, make sure you seek legal counsel BEFORE you sign anything.

Impact of SBA Regulations, Policies, and Credit Requirements

The SBA is very concerned about improper business evaluations as our concern is with overstated valuation models of businesses being purchased, overstated collateral in general, and incorrect depiction of the financial condition of the business being purchased. Many in the business community think they have sound advice concerning the concept of collateral valuation and business acquisition valuation models but some get them mixed when they are two separate, and distinct, issues in the eyes of the SBA.

SBA regulations require the lender (thus the borrower) to obtain a qualified <u>independent</u> individual to determine the value of the small business, and the loan file is well documented regarding the valuation including a detailed analysis of any goodwill. This is especially true if the valuation was provided by an unlicensed real estate agent, business broker, packager or other third party and the amount of goodwill appears high for the type or place of business. Participating lenders in SBA's loan programs are required to utilize the valuation methods recommended by SBA and discussed in SOP 50 10 4E to value the business being reviewed. Additionally, lenders are required to obtain two appraisals, including one requested directly by the lender if the business has been transferred within 36 months of the date of loan application.

Business Valuation

SBA lenders are required to determine the value of a business as a key component to their analysis of any loan application for a change of ownership as the need for an accurate valuation is true regardless of whether the financing is structured as an asset purchase or a business purchase. The lender must do its own valuation of an applicant. Again, this is true regardless of how many other business valuations may have been performed by other interested parties. If the lender uses a series of "in-house" business valuation methods for its non-SBA loans, it should also use them for its SBA loans, and should document this process in the SBA loan file.

Real Estate Appraisals

All lenders must assess the value of the collateral to be taken as security for every SBA loan. When commercial property is the primary collateral, either a real estate assessment or an appraisal is required, depending upon the estimated value of the real property.

For businesses <u>that have been transferred within 36 months</u> prior to the date of the loan application and the real estate is valued at over $100,000, SBA requires <u>two appraisals</u> of the business real estate, including one requested directly by the lender. Appraisals are not required for loans where the real estate is valued at $100,000 or less. In order to ease the burden on small businesses, SBA allows the lender the option of replacing the second appraisal with one of the following:

a. A "review" of the first appraisal by another appraiser (selected directly by the lender), or;
b. If the first appraisal was requested by the lender, a site visit by a senior member of the lender's staff may be substituted for the second appraisal. The lender must document the file and include the date of the visit and a description of the items reviewed on site.

Verification Seller Financial Information

SBA requires that lenders "verify the historical profit and loss statements of the business for the last 2 years" as required by SOP 50-10 4E. Verification of the information will be accomplished by verifying the tax returns. In cases where verification of tax returns is not an option, other forms of verification should be used. This is particularly true in the case of business valuations where there is insufficient independent information available (e.g., where a division of a business is being sold). Finally, the source of information (e.g., the lender, a packager, broker, agent, an accountant, the applicant, etc.) must be identified in the lender's documentation.

Change of Ownership

In all change of ownership loans, SBA requires lenders to maintain an arms-length transaction, accurate determination of business (emphasis added) value, and properly document your loan file. The business valuation model (or appraisal) is different in many respects from a traditional CRE appraisal. We recognize that some CRE appraisals include some of the same methods found in SOP 50 14. However, that is not our intent or the focus of a CRE appraisal which is to identify the value of the building and not necessarily the business.

Lenders are required to obtain two business valuation models (appraisals), including one requested directly by the lender if the business has been transferred within 36 months of the date of loan application, except of course the second review discussed previously. To help meet the arms-length transaction and accuracy requirements, many lenders use business evaluations that are prepared by business valuation specialists (usually specialized CPA's) in accordance with *American Business Appraisers National Network of Business Evaluation Firms* valuation guidelines.

These highly specialized appraisals meet the requirements of SBA change-in-ownership lending. They will always include a real estate appraisal if the business acquisition includes real estate. Additionally, these valuations usually include multiple valuation methods found in SOP 50 14 and include a more detailed analysis of the prior owners historical financial results, intangible asset valuations, and accurate valuations of other assets such as M&E, inventory, and receivables. They even verify the accuracy of the numbers by reviewing the source documents. Their final "on-going" valuation value is generally very accurate. Because the model is done by a CPA, this meets the due diligence requirements of someone with knowledge and expertise at completing this requirement.

Typical SBA Collateral Valuation Model

Real Estate Appraisal	$ 300,000
Less Liquidation Costs @25%	-75,000
Less Care & Preservation Costs @4%	-12,000
Collateral Value	$ 213,000
Less Outstanding Liens	- 100,000
Collateral Value (Collateral Protection)	$ 113,000
SBA Loan Amount	$ 125,000
Collateral Protection	113,000
Liquidation Percentage	90%

SBA DOES NOT USE LTV FORMULAS.

Financing a Business Purchase or Sale with an SBA Loan

Financing programs provided by SBA vary according to a borrower's financial need. The 7(a) Loan Guaranty Program is the SBA's primary loan program and most frequently used for the purchase of a business. The SBA reduces the risk to lenders by guaranteeing major portions of loans made to small businesses. This enables the lenders to provide financing to small businesses when funding is otherwise unavailable on reasonable terms. The eligibility requirements and credit criteria of the program are very broad in order to accommodate a wide range of financing needs.

When a small business applies to a lending institution for a loan, the lender reviews the application and decides if it merits a loan on its own or if it requires additional support in the form of a SBA guaranty. If SBA backing is necessary, the loan is forwarded to SBA for review. In guaranteeing the loan, the SBA assures the lender that, in the event the borrower does not repay the loan, the government will reimburse the lending institution for a portion of its loss. By providing the guaranty, the SBA is able to help tens of thousands of small business every year gets financing they would not otherwise obtain.

When purchasing a business, the lender will need to obtain financial information about the business. This information is critical, as it will help establish the viability of the project, ability to repay and if the purchase agreement meets SBA's guidelines. If unavailable, you will need to prepare a comprehensive Business Plan to show the lender you can repay the loan.

The information the lender will require includes copies of the sellers interim financial statement and those for the last three years, copy of the purchase agreement, and documents to support the valuation of assets or other recognized examination techniques such as a *Business Appraisal.* It is critical to make sure the business has been properly valued and all amounts in excess of the assets (i.e. Goodwill) are justified and documented by a certified business appraiser or Certified Public Accountant.

Additionally, you will have to obtain specific information on exactly what the loan funds will be used for. For example, inventory, leasehold improvements, and equipment. They will also need to know how much you, the borrower, will be putting into the project. Most lenders will require from 10 to 50% based on the industry and overall credit risk. Finally, and probably most important, the lender will want to see cash flow projections based on historical data to assure that the business will provide sufficient revenues to service the new debt to acquire the business. The sellers historical financial statements will help give creditability to your projections.

Since many businesses today provide a service, there often is not the collateral or "hard assets" available to help secure the loan. Therefore, the lender will frequently want additional collateral in order to provide a certain "comfort level." The SBA guarantee will allow the lender to provide extended terms (up to ten years on working capital, 15 years on equipment and 25 years on real estate) which will substantially enhance cash flow availability.

For these reasons, the SBA 7(a) Loan Guarantee Program, in many instances, will be the difference between getting the needed financing and being declined. To qualify for a SBA guaranty, a small business must meet the 7(a) criteria, and the lender must certify that it could not provide funding on reasonable terms without a SBA guaranty. The maximum loan amount is $ 2 million.

The process starts by the businessperson submitting a SBA loan application to a lender. If the lender approves the loan subject to a SBA guaranty, a copy of the application and credit analysis are forwarded to the SBA office. Lenders who are in the Preferred Lender Program can assign the SBA guarantee to a loan without submitting it to a SBA Office. After SBA approval, the lending institution closes the loan and disburses the funds. There are no balloon payments, prepayment penalties, application fees or points permitted with 7(a) loans. Repayment plans may be tailored to each business. For more information about financing the purchase of an existing business purchase or sale, call SBA at (602) 745-7200.